PROBLEMS ENCOUNTERED BY INTERNATIONAL BANKS

IN FINANCING PROJECTS IN THE

PEOPLE'S REPUBLIC OF CHINA

by

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ABSTRACT

It is well recognised that the capital requirements of China's modernization programs are substantial. Funds provided by international commercial banks in financing projects in China are perhaps the most important sources of capital.

This study aims at exploring the major issues facing the international banks in their provision of financings in China.

Issue One "The Meaning of Project Financing in China" outlines the form and structure of the latest project financing scheme used in China, with particular emphasis on the security structure.

Issue Two "Guarantee" explains the importance of a guarantee in financing, and Chinese policies on the provision of such guarantees.

Issue Three "What is a Sovereign Credit?" tries to identify the different risk levels of lending to China against the general idea that all loans are the responsibility of the State.

Issue Four "Project Feasibility" highlights the importance of project feasibility studies conducted by banks, with examples of two projects where severe problems developed because of incomplete feasibility

studies.

Issue Five "Project Operation" discusses the potential operational problems facing the projects and ways to tackle them.

Issue Six "Taxation" describes the withholding tax issue and the tax spacing scheme relating to financings.

Issue Seven "Documentation" illustrates the various issues of disagreement between the borrowers and the lenders over the loan documentation.

Case studies are extensively used throughout the study to illustrate the practical approaches being conducted by the international banks in dealing with the issues.

In summary, international lenders should look carefully into the feasibility of a project, and place special emphasis on the ability of the project to generate foreign exchange earnings. The strength and commitment of the sponsors of the project are also extremely important. Furthermore, it must be ensured that all aspects of a project including the financing arrangements, comply with State policies and that all necessary approvals have been obtained.

To facilitate the arrangement of financings, China should also make its policies more specific and clear on the various aspects of the financings, such as guarantees. Information about such policies and about the borrower/sponsor/project should be disclosed as much as possible. More importantly, laws and regulations defining the rights and obligations of the parties must be made available. For example, the exercise of security rights by the lenders. Improvements in these areas will provide a better environment for the international banks in lending to projects in China, this speed up the economic development of the country.

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CHAPTER I

INTRODUCTION

It has been well recognised that China's foreign exchange needs are enormous. One source suggests that in the next 15 years, China will need to raise at least US$200 billion in order to accomplish the economic goals it has set for the year 2000. It is estimated that even for the conservative Seventh Five-Year Plan (1986-1990), about US$50 billion will be needed for the development of coal mines, offshore and onshore oilfields, the improvement of railroads, ports, air transportation, power and telecommunications, and the modernisation of existing factories. According to the latest statistics, China's foreign exchange reserves stood at approximately US$13 billion as of 1987.

Even if these projections are overstated, there is little doubt that the capital requirements of China's modernisation programs are substantial. The issue, then, is whether the country can attract sufficient funds to meet its anticipated development needs.

I think the answer is yes, and for the following two reasons.

First, the worst sovereign risks for commercial banks exist principally in Latin America and Eastern Europe, and with the exception of a few countries, Asian sovereign borrowers enjoy good credit ratings. The external debt of China is very low compared to most other developing countries. In general, international banks are willing to lend to China.

Second, major problems involving loans for projects in China have been relatively few. Notwithstanding difficulties with a few projects, the recent record of bank lending to China projects has been satisfactory. While marginally economic projects will find it difficult to attract bank funding without some form of sponsor or government support, worthwhile projects should be able to attract finance.

It is estimated that since China embarked on the modernisation programs, funds provided by international commercial banks have amounted to US$2 billion. Commercial financings will undoubtedly continue to be the most important source of capital for the economic development of China in the years to come.

The objective of this study is to analyse some of the problems encountered by international commercial banks in financing projects in China. We will look at how and to what extent the following issues will influence a commercial bank's decision to lend to projects in China :

1. the acceptability of the political environment;

2. the availability of foreign exchange for debt repayment;
3. the economic viability of the project;
4. the creditworthiness of the the project sponsors, and especially the sources of government support;
5. status of the project in the national economy and the approval system;
6. the seniority and security of the loan, and government approval or recognition of such security;
7. the legal aspect of commercial financing, ie, internationally acceptable legal documentation and exercise of security rights;
8. taxation issues, especially the imposition of withholding tax for foreign borrowings;
9. quality control and progress monitoring for projects;
10. the level of compensation relative to the perceived risk.

More importantantly, I will discuss how these problems are presently dealt with by the banks and to what extent those solutions are effective. Lastly, recommendations will be given for the various issues, based on the writer's own experience in the areas concerned.

The study has a strong practical bias. Materials will be drawn from different kinds of project financings completed during the past two to three years to illustrate the problems and the solutions. A list of these examples includes:

1. a US$475 million 12-year partial recourse project financing for the development of the An Tai Bo Coal Mine in Shanxi Province signed in December 1986;
2. a HK$4.2 billion 12-year project financing for the construction of the coal fired power plant in Shajiao undertaken by Hopewell Group in Hong Kong in April 1986;
3. a US$175 million 10-year financing for the construction of the Shanghai Exhibition Centre undertaken by the Portman Group in U.S. in Shanghai in late 1985;
4. a US$90 million 7-year loan for part of the construction of a power plant in Shanghai undertaken by Huaneng International Power Development Corporation in November 1987;
5. a US$255 million loan for the financing of the construction of the power plant in Nantong and Shijarchong undertaken by Huaneng International Power Development Corporation.
6. a US$45 million loan for the construction of the Shangri-la Hotel in Beijing.

Furthermore, two problem projects will be discussed:

1. a US$96 million loan signed in 1984 for the development of the Nanhai Oil Centre Project in Guangzhou in which the project could not be completed for various reasons;

2. a US$64 million loan signed in 1984 for the development of a pier and related apartment project in Zhuhai. It was discovered only after the construction had been completed that the economic viability of the project was a total failure.

CHAPTER II

METHODOLOGY

The objectives of the research, as outlined in Chapter I, are:

1. to identify the problems faced by international banks in financing projects in China;
2. to examine the ways and means adopted by the banks in dealing with the problems;
3. to explore alternative solutions and recommendations for both the banks and the PRC government in order to facilitate the future development of financing activities in China.

The study will be based on data and information collected over the past 24 months by the writer. These include published and unpublished materials on financing schemes actually used for projects in China. Case studies will be extensively used throughout the research to reflect the practical aspect of the subject.

The following research approach will be used :

1. As a first step, the problems for each specific issue will be spelled out. For example, what are the problems faced by the banks with respect to the foreign exchange issue; what is the impact on

financing terms and conditions as a result of the interest withholding tax requirement?

2. Then I will examine the extent to which these problems affect financing decisions.

3. Relevant case studies will be used to reflect the problems mentioned in the last two sections.

4. Lessons will be drawn from the practical approach adopted by the banks in dealing with the problems.

5. As a further step, I will try to explore alternative solutions for certain specific problems.

6. Lastly, recommendations will be made to the banks and the PRC government on areas for improvements in their practices. The writer will endeavour to analyse the subject not only from an international banker's point of view, but also look at it from the angle of Mainland China. This is made possible by discussions with major financing institutions like the Bank of China and the China International Trust and Investment Corporation, which are involved one way or another in all major project financings in China.

CHAPTER III

ISSUE ONE -

THE MEANING OF PROJECT FINANCING IN CHINA

Project financing is the term commonly applied to a form of limited recourse financing for a new, capital intensive, single purpose entity from which expected cashflow is considered the primary source of repayment, even though the loan may be supported by various technical and/or financial commitments from the sponsors, output purchasers, or others, and most often secured by a charge on the project assets.

There are three generic types of project financing, which relate to the amount of support that the sponsor(s) will give to the lender(s) :

1. Full recourse
2. Partial recourse
    a. Partial recourse at all times
    b. Full recourse until certain conditions are met at which it converts to non-recourse
3. Non-recourse

Occasionally one defines project finance as confined solely to non-recourse lending (type 3), where the project cashflow and any residual asset values are the only sources of repayment. The non-recourse form of financing, though applicable in a capitalist economy, cannot be applied to the projects in China. This is due to the following two reasons :

1. China is a centrally planned economy. All land and properties belong to the State and cannot be transferred or assigned without the approval of the authorities. Because the security of a project's assets is essentially a bundle of rights, and there is legal uncertainty as to how the Chinese government will permit an assignment of those rights in case the lenders need to enforce their security, the lenders cannot count on or put a realisable value on the project assets. As a result some form of guarantees or undertaking by the sponsors of the project is required.

2. Apart from the legal considerations, the lenders often wish to structure the financing with recourse to the sponsor(s), or any other parties in the project in order to ensure the commitment and support of the sovereign China, which is particularly important in terms of foreign exchange availability and infrastructure facilities back-up.

I shall now discuss a unique project financing completed at the end of 1986 in China which illustrates, among other interesting features, how the security package was structured to the satisfaction of both the lenders and the sponsors.

The US$475 million 10-year financing for the development of the An Tai Bao Coal Mine in Shanxi Province, better known as the Pingshuo Coal Mine, was the latest and the most sophiscated project finance arranged so far in China. This landmark deal not only signified the successful venture of Dr. Armand Hammer (Chairman of Occidental Inc.) in China, but it also showed how the international banks strove their best to apply the traditional project finance concepts in a centrally planned economy.

The financing took about four years to arrange and drew some of the best brains in project finance from the entire world. The five arranging banks were the Bank of America, the Industrial Bank of Japan, the Royal Bank of Canada, Credit Lyonnais and the Bank of China, with participation of forty other international banks. It also won an award as one of the "Deals of the year - 1986" by the publication Trade Financing, Euromoney.

The purpose of the loan was to finance the construction of the Pingshuo Coal Mine which was a joint venture between Occidental and the Chinese government through the Bank of China Trust and Consultancy Corporation. It was essentially structured as a partial-recourse project financing.

The loan was divided into four tranches (A, B, C and D) of US$230 million, US$70 million, US$100 million and US$75 million respectively, each representing a different aspect of financing requirements as well as credit risks structure.

Tranch A was a direct loan provided by the lending syndicate, and Tranch B was a guarantee facility provided by the lending syndicate to the Canadian Export Credit Agency for the export credits provided by the latter in relation to the equipment purchases from Canada.

Both Tranches A & B are unconditionally guaranteed by the sponsors before the construction of the mine is completed. Once the mine completion test is fulfilled, the sponsor guarantee will lapse and the primary source of repayment of the loan principal and interest comes from the cash generated from operations.

How can the banks ensure that there is sufficient cash generated from the sales of coal produced from the mine? Similar to other project financings, there is an offtake undertaking by a buyer. In this case, China National Coal Import & Export Corporation ("CNCIEC") under the Ministry of Foreign Economic Relations & Trade ("MOFERT") undertakes to take up all the coal output from the mine, based on the market price. However, CNCIEC has no obligation to provide any other forms of support if there is not enough coal produced resulting in a deficiency in income. In view of the status of CNCIEC, the lending syndicate in fact relies on the Chinese government as the ultimate obligor for this offtake undertaking.

In addition to the production risk, the lenders also have to consider the risk of coal price fluctuations which will affect the project incomes. This leads to our focus on Tranches C and D. Tranch C is a direct loan to the project. However, unlike tranches A & B, it will remain sponsor guaranteed even after mine completion unless the coal price reaches US$39 a ton, then 50% of this tranche will be converted into a stand-alone basis, and only if the coal price reaches US$42 then the whole tranche will not be sponsors guaranteed. The rationale behind this arrangement is that the project will generate ample revenues under the higher coal price levels which makes a guarantee relatively less important.

Tranche D offers an emergency stand-by facility to cover any temporary shortfall in revenues. In view of its nature, it will always be sponsors guaranteed throughout the loan tenor.

If the lenders need to enforce their security rights due to such reasons as the project cannot continue or non-repayment of debt, it is always subject to the approval of the MOFERT. The chance of obtaining such approval is unknown since there is no precedent in the past and there is no legislation governing MOFERT's decision.

In view of such uncertainty, the lenders require an additional security from the sponsors, ie, if MOFERT does not approve the exercise of security right, the sponsors undertake to repay the outstanding loan amount based on a predetermined formula. The multi-level risk bearing and security structure makes the Pingshuo Coal Mine financing one of the most sophisticated project financings even by international standards, and certainly poses itself as a precedent for future project financings in China. It is a successful project financing by all means, particularly in the provision of a security structure which offers an acceptable solution to the lenders and the sponsors.

Until a comprehensive set of legislation governing commercial activities in China is completed, we can see that the area of security rights remains a problem for the international banks in providing financings to China, and perhaps the structure of Pingshuo Coal Mine financing represents the best solution available.

However one should not expect simply that the Pingshuo structure will become the blueprint for future project financing in China. Pingshuo is such a visible and important state project that it draws the extensive support and commitment by the Chinese government, which most often is not available to other industrial or commercial projects in other provinces or cities, and some other form of project financing is therefore required. This will be discussed in the following chapters.

CHAPTER IV

ISSUE TWO -

GUARANTEE

The issue of guarantee is perhaps the most widely discussed topic among the international banks in financing projects in China. This is partly due to its importance in a financing package, and partly due to the uncertainties involved.

The importance of guarantees is because of the following:

1. As described in the previous chapter, the uncertainties involved in enforcing the security rights by the lenders makes it necessary to obtain a guarantee.
2. A sound guarantee enhances the overall creditability of the project, particularly in a situation where the borrower is a new joint venture with no operation track record.
3. The Chinese government's policy on foreign exchange allocation and availability may change, and this may have an impact on the financing involved. A guarantee serves to ensure that the loan repayment can be met.

Important as such, it is interesting to know that the issue of guarantee causes a lot of confusion among the foreign banks. This is because the government's policy on the issuance of guarantees has been constantly changing without clear notification and guidelines given to the foreign bank! Most often the policies are outlined only in internal documents circulated within the government circle. These are not available to outsiders, including foreign banks.

Another problem facing a foreign bank is that it is difficult to ascertain whether there is any limit to the guarantees issued by the authorised institutions. Many of these institutions do not provide any financial information about themselves.

Therefore we see that guarantees issued by the Bank of China or China International Trust and Investment Corporation ("CITIC") are most welcomed by the foreign banks because of their clearly stated authority to deal with foreign currencies transactions and their proven financial stength.

There were examples in the past where some Chinese organisations which issued guarantees later found out that they were in fact not authorized to do so. Although these guarantees have ultimately been honoured, it nevertheless caused substantial embarassment to both the Chinese government and the foreign bankers, and created uncertainties among the lenders.

Based on information available, the current policy on

the issuance of guarantee is as follows :
There is an official list of Chinese organisations that have authority to provide guarantees for foreign currency loans. These include the Bank of China and its subsidiaries, CITIC, other financial institutions under the central and/or provincial governments, and branches of foreign banks in China, and a few others. (Appendix 1)

If any other entities wish to become a guarantor, they must then apply and obtain special approval from the State Administration of Exchange Controls ("SAEC"). In fact SAEC approval must be obtained before a project can borrow funds from foreign banks.

The lastest policy on the issuance of guarantees was announced in February 1987 which stipulated that financial institutions can issue guarantees up to 20 times their paid-up capital, and non-financial institutions are allowed to guarantee an amount equivalent to their foreign exchange reserves and incomes.

As a rule of thumb for foreign banks, the approval of SAEC must be obtained as evidence of authority to guarantee and to borrow. The form of guarantees used can be illustrated by the following two project financings completed in China.

The first example is the HK$4 billion financing completed in mid-1986 for the construction of the coal-fired power plant in Shenzhen which is a joint venture between the Shenzhen Municipal Government and the Hopewell Group in Hong Kong.

Under the financing scheme, the Chinese party undertakes to supply the coal required by the project, to purchase the electricity output at a predetermined price, and to provide subordinated loans to the project when expenses exceed revenues. Such obligations undertaken by the Chinese party are guaranteed by the Guangdong Internatonal Trust and Investment Corporation ("GITIC"), one of the authorized guarantors.

Prior to completion of construction, the lenders are relying on the sponsors to complete the project with the support of a performance bond issued by a third-party international bank. After the construction is completed and operation commences, the lenders will rely on the project cashflow as a first way out, and the financial support by the Chinese party guaranteed by GITIC as an alternative source of repayment.

In comparison with Pingshuo Coal Mine, this financing arrangement offers a better security position to the lenders since the Chinese party has to undertake to provide funding support in case there is a cashflow shortfall.

In certain projects where cashflow is not the primary source of repayment, the lenders rely heavily on the guarantee. This can be illustrated by the US$230 million loan financing to Huaneng International Power and Development Corporation ("HIPDC") in mid 1986 for the construction of coal-fired power plants in Nantong and Shijiazhuang. HIPDC is a state-owned corporation under the State Council and is commissioned to construct coal-fired power plants as stated in the Seventh Five Year Plan.

Since these projects aim at providing electricity for domestic usage and no foreign currency income can be generated, the source of repayment does not come from the projects but rather from an allocation of state funds. A guarantee by the Bank of China is provided to the lenders. However only very limited information about the project is available.

In this situation, the lenders are in fact considering the financing as a sovereign borrowing rather than a project financing.

For some projects, a guarantee does not necessaily come from the Chinese side. Indeed it can be a guarantee provided by the foreign sponsor of the project or a joint or several guarantees by both the Chinese and the foreign sponsors.

For example, in the US$175 million financing for the construction of the Shanghai Exhibition Centre in Shanghai, 70% of the loan is guaranteed by Bank of China Trust and Consultancy Corporation ("BOCTCC"), with the remaining 30% guaranteed severally by the foreign sponsors - the Portman Group and the American International Group of USA and Kajima of Japan.

In the case of the China Hotel in Guangzhou, the financing is guaranteed entirely by the foreign investors. However, this is not common because the foreign investors normally are not willing to guarantee a loan for a project in which the assets cannot be assigned or tranferred.

We see that institutions like the Bank of China, which have issued a relatively large number of guarantees in the past, are becoming more and more reluctant to act as guarantors except for the State projects. The reasons are firstly to discourage an over-reliance on the guarantee by the lenders; and secondly, as there are increasing investment activities, it is difficult for a guarantor like the Bank of China to monitor the successful operation of each project.

To deal with the issue of guarantee, the foreign banks should keep in mind the following principles :

1. Always refer to the latest list of authorized guarantors to ascertain the legitimacy of a guarantee, otherwise one must obtain SAEC's special approval.
2. Always analyse the capability and strength of the guarantor in relation to the scale of the project. Most often financial information is not available, and one must look into the status of the guarantor

in the government hierachy to determine its capacity.

3. Remember that a guarantee is only the last way out for the lenders. One should not over-emphasis the importance of a guarantee and overlook the underlying feasibility of the project and its cashflow position. Having a guarantee does not mean that the project is problem-free!

CHAPTER V

ISSUE THREE -

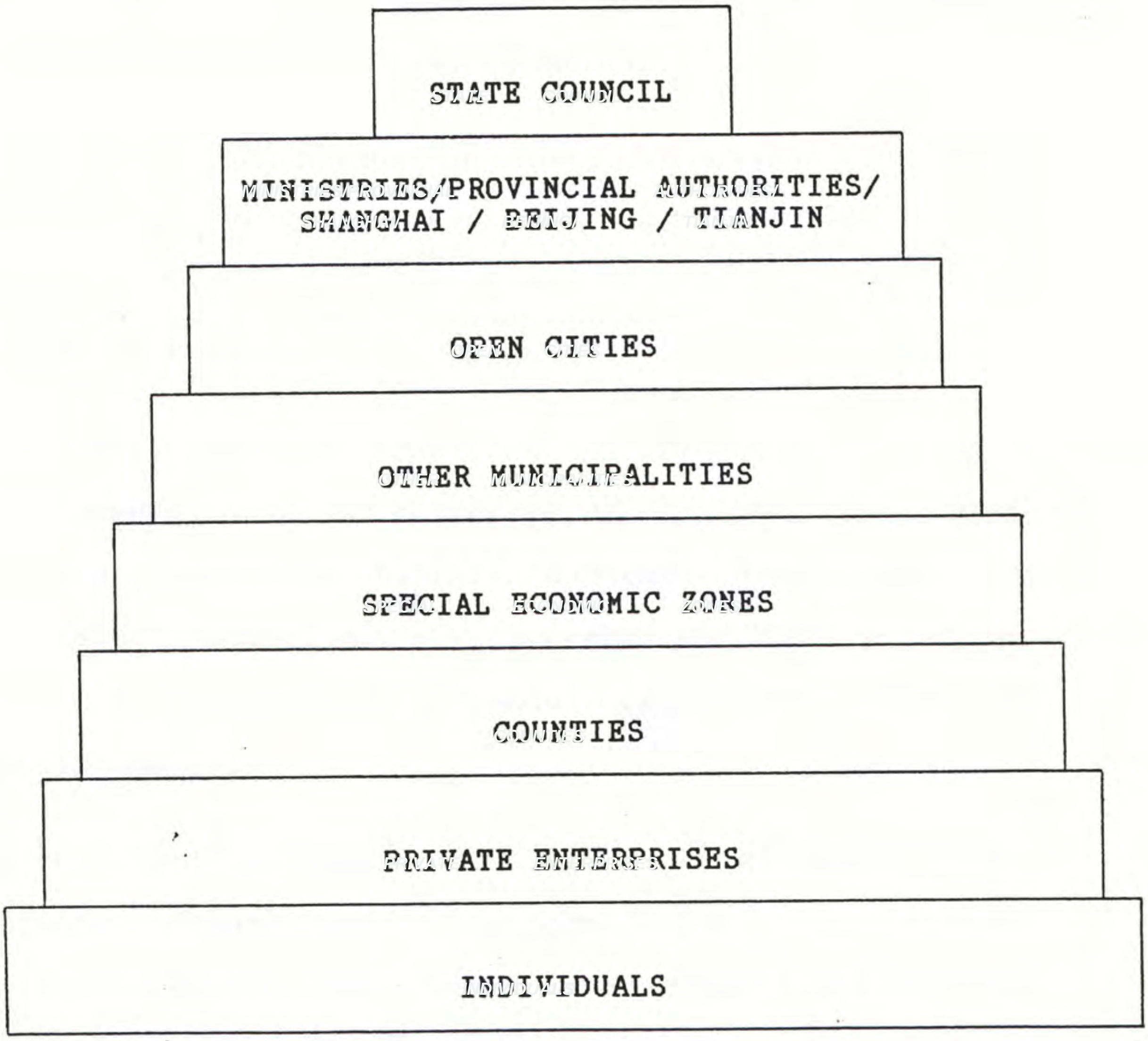
WHAT IS A SOVEREIGN CREDIT?

The foreign banks are often faced with the question of what constitutes a China sovereign risk in making a credit decision.

Should a commercial joint-venture hotel project guaranted by one of the authorized guarantors be classified as a sovereign credit? Or is it correct to consider that a factory operation in the special economic zone has the same credit status as the Pingshau Coal Mine project, although both of them are joint ventures representing Chinese government interests?

To identify what is a genuine Chinese sovereign credit is important for the international banks both for policy and for practical reasons. This is because the identification gives guidelines and indications as to the overall quality of the projects, the repayment capabilities, and the appropriate pricing in relation to the perceived risk level.

China operates substantially as a centrally planned economy. Accordingly, all levels of government are ultimately under the authority and responsibility of the central government (the "State"). Sovereign risk therefore is the credit responsibility assumed by the State for an obligation of one of the entities over which it has authority and responsibility.



The highest organ of state administration and the executive organ of state power is the State Council. Ministries are industry instrumentalities of the State and, as such, are executors of State policies. In addition to the named Ministries, and at the same level, there are a variety of commissions and other organizations, such as the People's Bank of China and CITIC.

Provinces are geographic instrumentalities of the State and, like the Ministries, are executors of State policies. There are presently twenty-three provinces (as well as five autonomous regions).

In terms of status in the government hierachy, provinces are at the same level as Ministries. Three cities, Beijing, Shanghai and Tianjin, are at this level as well.

All municipalities report to the relevant provincial government, with the exception of the fourteen 'open' cities, the four Special Economic Zones and the municipalities of Beijing, Shanghai and Tianjin which, as noted, report to a special department under the State Council.

Open cities, in fact, are other municipalities. Their special classification as open cities, like special Economic Zones, are a result of government policy which can be changed. Hence an open city may lose its status as an open city, but it is nevertheless a city (ie, municipality); a Special Economic Zone in losing its status is nothing.

To what extent an entity can be regarded as sovereign risk is of course subject to the assessment of the individual banking institution. However it is a fact that the lower one goes down the authority and responsibility pyramid, the higher the degree of risk - a concept which has applicability in any country.

CHAPTER VI

ISSUE FOUR -

PROJECT FEASIBILITY

As mentioned in the previous chapters, project financings in China are seldom structured on a stand-alone basis. Some form of guarantees is usually included as part of the security structure. Relying on a guarantee from a sovereign entity and the good credit record of China, the lenders sometimes may lose sight of the fact that the primary source of repayment for the financing should come from the operational cashflow and that a guarantee can only be regarded as an extra benefit and a last way out.

Indeed the fundamental question bankers should ask is whether the project is feasible or not, instead of who will be the guarantor. However, there is no easy answer to this question as China is a centrally planned economy and, due to the shortage of market information, it is often difficult to obtain the kind of data required to make an indepth feasibility analysis.

Before making an independent assessment, a quick and practical approach for the lenders is to check whether the project under consideration has been `approved´ by the relevant authorities in China.

Under the present system, all projects have to be approved by the Local Planning Commission ("LPC") or by the State Planning Commission ("SPC") if the value of the project exceeds local approval authority. Both the LPC and the SPC are offices directly under the State Council. Only the State Council may approve projects involving a total investment of Rmb 100 million or more. The approval limits for certain provinces, special Economic Zones and open cities are given in Appendix 2.

To qualify for approval, a feasibility study has to be prepared, normally by the Chinese entity involved as a joint venture partner or sponsor. The feasibility study covers all major aspects of the project and a typical checklist is shown in Appendix 3.

To ascertain a project's approval status is important for the following reasons:

1. Most important of all, it ensures that a feasibility study has been made and that it is acceptable on economic grounds.

2. It ensures that the project is in compliance with the the government's policies with regard to specific industries and/or geographical areas.

3. It confirms the status of the project - whether it is a state project or commercial joint venture project.

The next question asked by the bankers, then, is how realistic the feasibility study is. Due to the limited resources available, it is often difficult for the lenders to conduct independent assessments of the business projections prepared for these feasibility reports.

The feasibility of a project is sometimes either overstated or understated by the sponsors due to various business and taxation reasons. The abovementioned problem is particularly obvious among the joint ventures in the Special Economic Zones where a high degree of freedom is granted by the central government. I will discuss two of these problem projects in the following:

A joint venture was formed in 1984 in Zhuhai Special Economic Zone for the development of the Zhuhai Deepwater Port Project by a corporation under the Zhuhai municipal government, a Hong Kong company and an entity under the Guangdong provincial government. A syndicated project loan of US$ 64 million was raised through the Hong Kong party with an unconditional guarantee by the Zhuhai party.

The construction of the project ran well and completion was on schedule. However the problem is that since the commencement of operation, incomes have been barely enough to cover operating expenses not to mention interest payments and repayment of loan principal.

What's wrong with the project?

The project was originally designed to provide port and residential facilities for expatriates working on oil exploration projects in the South China Sea. It was reported to be the only deepwater port around the area. The sluggish business demand is attributed mainly to the unsatisfactory offshore oil development and also partly due to the insufficient transportation network linking the port with other parts of the province. For example, it takes about four hours to connect the port with the nearest railroad.

Furthermore, while the port has a maximum loading capacity of around 2 million tons per year, it will need a loading of about 1.8 million tons per year in order to break even, i.e. to meet all operating expenses and financing payments.

In retrospect it seems that the inital feasiblity study was overly optimistic without any in-depth consideration about the demand situation, the infrastructure support, the operating expenses, etc.

The fate of the project had not been decided at the time this paper is written, but one thing for certain is that some form of project and loan restructing is required. The lenders can now only rely on the good faith of the sponsors and the guarantor to honour their financial obligations.

Another problem project relates to the construction of the Nanhai Oil Center Project in Guangzhou. The joint venture was also established in 1984 between a Chinese entity of Guangdong province and a Hong Kong investor. The project calls for the construction of a hotel, apartment and commercial complex in the heart of Guangzhou city costing US$86 million. Again it was to cater for the expatriates working on oil projects in the South China Sea.

However the construction came to a halt in mid-1986 essentially for two reasons:

1. There was a substantial cost over-run and construction delay, US$ 20 million was spent with only the basement level of one-third of the construction site completed. The reason was due to some unforeseen engineering difficulties.

2. At the same time, the hotel market in Guangzhou had been deteriorating due to over-supply. The average occupancy was only about 50%, which is unlikely to generate sufficient incomes to cover operating and financing expenses.

The loan amount was ultimately repaid in full by the guarantor (the Chinese joint venture partner) in early 1987. Although the lenders were financially unharmed, it did leave substantial embarrassment for both the lender and the Chinese.

Some conclusions can be drawn from the above two cases:

Even if the project itself is approved, the underlying feasibility may not be realistic and the lenders should exercise due diligence in independently assessing the creditability of the project.

Business situations are unpredictable, even in a centrally planned economy like China. For example, nobody can predict what is the outcome of the oil exploration programmes in the South China Sea. As a result, lenders should never allow basic credit judgement to be substituted by the provision of guarantees by the sponsors or other parties of the projects.

CHAPTER VII

ISSUE FIVE -

PROJECT OPERATION

The successful completion and operation of a project is of primary concern for the lenders since this is where the source of loan repayment comes from.

A handful of problems can happen to a project in China such as the shortage of labour, lack of infrastrutural facilities support, supply of power and water, raw materials supply, skills level of Chinese staff, political uncertainties, cost overruns, operation efficiency, and others.

It is impractical for the lenders, given their limited resources, to closely monitor the progress of a project, and most often it is left to the sponsors to ensure that the above issues can be effectively dealt with as they arise.

To make sure that a project can proceed smoothly, the lenders should look into the following elements when considering the extension of financings:

1. Who is the project operator?

   The project operator need not necessarily be the sponsors, especially when the sponsors are not experienced in the industry and act purely as the investors. This applies more often to the hotel projects in China where the lenders will normally insist that an international reputable hotel operator be appointed to run the hotel as a condition precedent for providing the loan. Preferrably the hotel operator has previous experience in China as well.

For industrial and energy projects, it is usually the foreign partner who will provide the technical know-how and actually be involved in the running of the operations for a certain period of time, say five to ten years after the project completion. During this time, the foreign partner will also responsible for training the local staff to ensure a smooth transition after the inital period.

In view of the fact that China is still a developing country, an experienced operator is invaluable for both the investors and the lenders as he will contribute greatly in solving problems and maintaining quality standards of operation.

2. Who is the sponsor from the Chinese side?
Although the Chinese sponsor most often will not be involved in the operation of the project, its assistance is very important to the successful running of the operation, especially in the areas

of negotiation with relevant authories for the provision of infrastructure facilities, such as water and power, labour and raw materials.

The status of the Chinese sponsor is therefore an important factor for the lenders in considering the operating risks of the project. It is practically true that the abovementioned problems will either not happen or will be more easily solved if the Chinese sponsors are at the senior level of the government hierachy.

3. Independent engineer

For those large scale or technically complex projects such as a nuclear power plant, an independent engineer will be hired to advise the lenders on a regular basis of the progress and status of a project, and give early warning about potential problems.

If the above three parties are satisfactorily arranged, the chance of success of the project will be greatly enhanced.

I will discuss two projects in China that have shown operational problem in the past.

The first one was the HK$ 257 million joint-venture Ramada Renaissance Hotel in Guilin which was opened in May 1987. It was reported that even before the opening of the hotel, there was about HK$ 10 million lost in building materials, fittings, food, television sets and other items through alleged stealing.

At one time, the hotel was also cut for water supply, telephones, telex and electricity when there was a dispute with the local authorities about the fee charged. The local authorities also demanded that the hotel buy some twenty-year interest-free bonds before power was returned to normal.

Whether the incident mentioned above is true or not is being investigated by a senior offical from Beijing. However this is certainly not the kind of event that the lenders would like to see.

The other reported problem occurred to the Guangzhou Superhighway being built by the Hopewell Group of Hong Kong. The local authorities demanded that certain of the construction contracts be awarded to a Chinese local contractor who was unacceptable to the Hong Kong investor. Again the issue was taken to Beijing and the local authorities' demand was repelled by the Central Government.

The above cases show the kind of problems that can occur on projects in China. In both situations, the problems start at the local level and the involvement of senior officals from Beijing Central Government is required to solve them.

As a further recommendation, a comprehensive insurance coverage is essential for any project operations in China as an additional protection for both the investors and the lenders.

The normal package required by the lenders is an all-risks insurance coverage for the project. This will generally cover most of the risks involved in the operaiton except those of a force majeure or business risk in nature.

CHAPTER VIII

ISSUE SIX -

TAXATION

Among the various taxation issues, the foreign lenders are most concerned about the tax relating to the interest income from making loans in China. The tax is normally referred to as the interest withholding tax.

The standard withholding tax rate in China is 20% on gross interest income paid by a borrower in China to foreign banks. There is a concession for loans extended for projects in the Special Economic Zones and the fourteen open cities which reduces the rate to 10%.

The tax can be further reduced or wholly exempted if the loan or the underlying equipment related to the loan is provided at favourable terms.

First of all let us do some calculations to show the extent of the impact of the withholding tax on both the borrowers and the lenders.

Most of the financings in China are structured on a floating rate based basing on the London Interbank Offered Rate (LIBOR) or Hong Kong Interbank Offered Rate (HIBOR) plus a margin which reflects the risks level and the structure of the financing. The margin in fact is the net income received by the banks since LIBOR or HIBOR represents the lenders' cost of funds.

Consider the following example : if the six-month LIBOR is 9% and the margin is 1%, the gross interest rate would be 10%. If the withholding tax rate is 20%, the tax payment is then 2% which equals to 200% of the margin changed by the banks! Even at the concession rate of 10%, it remains equal to 100% of the margin.

There are certain conditions under which the withholding tax can be exempted in full. I pick up the two relevant ones for discussion as follows:

1. Interest on loans provided by foreign banks to Chinese State banks, trusts and investment corporations.
2. Interest on loans is less than or equal to the interbank offered rate, such as LIBOR.

In most of the state projects, such as power plants and oilfield development, the interest withholding tax is fully exempted through special approval. For other projects like joint venture industrial or hotel operations, the borrower has to bear the tax. However on one occassion a project loan was structed in such a way to tackle the issue of withholding tax payment.

In late 1985, a US$ 45 million loan was arranged for the construction of the Shangri-La Hotel in Beijing which is a joint-venture between a foreign investor and a Chinese corporation under MOFERT.

It is similar to other financing transactions for this type of hotel project except for one special feature, i.e. the foreign banks, instead of landing directly to the project, deposited the funds in the Bank of China which will in turn lend the funds to the project. The deposit agreement between the foreign banks and the Bank of China and the borrower is tied up with the loan agreement between the Bank of China and the borrower. That means the lenders will still rely on the project as the source of repayment without recourse to the Bank of China, which acts only as an intermediary.

The benefits of this arrangment are that funds placed by the foreign banks with the Bank of China are not subject to the withholding tax, and the Bank of China in lending to a local borrower is also not subject to the withholding tax.

The arrangment was a controversial one and the outcome was that the tax authority gave a special exemption for this financing but not its blessings for this kind of arrangment. It is understood that such a scheme will not be accepted by the tax authority.

Closely related to the withholding tax issue is the tax sparing scheme of financing projects in China.

Tax sparing can be a competitive tool used by the banks to pass on some of the tax credits they gain under a double taxation agreement between China and the foreign country to the borrower by quoting a lower interest rate.

Take the example of Japan, which had signed a taxation agreement with China. The result is that if China exempts the Chinese borrower from paying the withholding tax, the Japanses lenders can receive a tax credit from the Japanese tax authority equal to the amount of exemption. We show the following as an example:

If LIBOR equals 9% and the margin is 1%, the gross interest then is 10%, and the withholding tax (at 10% rate) would be 1%. Therefore the Japanese banks can get 1% tax credits in addition to the 1% margin, a total of 2%. In order to quote competively, the Japanese banks can lower its margin to 0.5% and still receive a total revenue of 0.5% (margin) plus 0.95% (tax credit).

Using this tax sparing scheme, the Chinese borrower is benefited, and logically they will borrow from the Japanese banks rather than from other international banks which quote a higher interest rate without the tax sparing benefits. This creates two concerns:

1. Non-Japanese banks are becoming uncompetitive in financing projects in China in terms of interest rate charges.
2. Over-reliance on funds provided by Japanese banks

may be considered as risky for China from a political and commarical point of view.

In the past nine months, there were at least three major syndicated financings using the tax sparing scheme: a US$150 million loan for the people's Construction Bank of China, a US$ 90 million loan for Huaneng International Power Development Corporation and a US$ 180 million loan for the China Petrochemical Corporation ("SINOPEC"). The margins were relatively very low in comparision with other project financings, and not surprisingly, almost all participating banks for these financings are Japanese banks.

Tax sparing in fact is a subsidy granted by the lending banks' country to the borrowers' country. It is expected that this type of tax sparing loan will continue to dominate the financing scene in China, with more countries such as West Germany and Brussels signing similar tax agreements with China.

CHAPTER IX

ISSUE SEVEN -

LOAN DOCUMENTATION

The preparation and negotiation of loan documentations for project financings in China has always been a lengthy process and often creates substantial conflicts between the foreign lenders on the one hand, and the borrower and guarantor on the other.

The writer recalls that in the earlier days, the Chinese borrower or guarantors would argue heavily on such issues as the choice of foreign law, place of jurisdiction, Chinese versus English language, and sovereign immunity.

It seems that the lenders have won an upper-hand on these issues and at present the Chinese generally will accept the lenders' requirements in these areas, with reference to the many precedent documents signed over the past few years.

However, based on the writer's latest knowledge, there are two fundamental issues which have not been satisfactorily compromised, as shown in the latest loan financing documents. Although they are essentially standard clauses in typical Eurocurrency loan documents, the Chinese borrower reacts in a different way:

1. Nagative pledge

   The lenders often require an undertaking by the borrower or the guarantor that they will not allow any charge on their assets without the prior approval of the lenders or giving the same security right to the lenders.

   Some Chinese entities, such as the Bank of China, consider that this is not acceptable in view of their extensive activities which may in some aspects require some form of mortgage of their assets.

2. Cross default

   The intention of the clause is to enable the lenders to call an event of default if the borrower or the guarantor fails to perform their obligation in some other loan agreements.

   Again some Chinese entities do not accept this based on the grounds that they have extensive contractual obligations which makes this clause impractical and unacceptable.

In fact, there was a loan scheduled for signing in August 1987 between the Bank of China and the foreign lenders, and due to the disagreement over the above two clauses, the loan could not be concluded.

In negotiating a loan document with a Chinese borrower, it is the writer's experience that a flexible approach should be adopted, such as giving in on some relatively minor issues and insisting only on the fundamental points.

This is perhaps due to the considerable difference between the Western and Chinese concepts of contractual obligations. The foreign lenders must bear this in mind in order to achieve a successful compromise with the Chinese.

CHAPTER X

CONCLUSIONS AND RECOMMENDATIONS

Ensuring foreign exchange revenues from a project is always a major concern of banks. If no direct foreign exchange is created by a project, the banks may require additional security for debt repayment. Therefore, most of the projects in China we have seen so far have centered on the services sector, eg. hotels, which have foreign patronage. Development of oilfields and coal mines can be feasible if a sufficient portion of production is exported to generate foreign exchange income in sufficient volume for debt repayment and profit repatriation.

Banks should review the feasibility studies that provide detailed information to allow a comprehensive evaluation of a project's economic viability, and to assess the level of risk to the cashflow available for repayment.

The financial strength of the project sponsors or other supporting entities should be examined for creditworthiness, and to ensure that each party can perform its obligations. While information on the foreign sponsor is readily available, it is often difficult to have access to vital information on the relevant Chinese entities necessary for a credit decision. In this regard, we could only hope that with the continuous development of China, more and more information about government policies and entities will be made known to the banks.

In the past, most banks extended financing on the assumption that all enterprises were state-owned, and that, since all proper approval should have been obtained before a foreign obligation was undertaken, therefore it could be deemed that the State is committed. However, the recent political and economic reforms have taken this unilaterally assumed 'comfort' away. Under the new system, government administration and enterprises are segregated, and enterprises are held accountable for their own economic efficiency. Time and again, government spokesmen have indicated that inefficient enterprises will be allowed to go bankrupt. These economic reforms, together with the installation of laws and regulations defining the rights and obligations of each party in a transaction have changed the complexion of lending to China.

Lending to projects in China has entered a more mature and sophisticated phase. Banks can no longer assume that the obligations of state-owned enterprises are the obligations of the State. Banks will need to conduct conventional analyses of financial, operational, marketing and management risks.

Closely related to this analysis is the availability of foreign exchange for an entity to honor its foreign exchange obligations, including the extension of foreign exchange guarantees. This must be carefully checked by the banks with reference to the approval list of SAEC's special approval. Banks should also know whether the obligation undertaken by a Chinese entity is out of proportion to its foreign exchange reserves.

In addition to the above, commercial lenders would seek a security over the assets of the projects. The ability of enforcement of security rights is still an area of uncertainty, and it is hoped that more clear legal guidelines will be provided by the Chinese government soon.

There are various risks in association with the operation of the project. Again this should be carefully assessed and handled by drawing the support of quality parties into the project. Promotion of the project to a senior or State level is practically very useful.

We can also see that the foreign banks would welcome the more direct involvement of the Bank of China or other State banks in extending financings in China, either as the leadmanager or the agent, or both, to ensure that the project is monitored by a recognised and powerful State organisation. Lastly, lenders should make a careful assessment of the total transaction risk relative to the loan pricing to be assured that there is sufficient economic incentive for the loan. The popularity of the tax sparing loan causes substantial difficulties for non-Japanese banks in making loans to China in a reasonably profitable manner.

Faced with all these problems, we see that some of the international banks have been withdrawing from the China market. At present it seems that the most active players in the China market remain the Japanese banks. On a long term perspective, such development may not be good for China, as this will limit the sources of funds for its extensive development plans. Therefore, the Chinese government must provide a better structure and environment for international lenders to participate in its economic development.

APPENDIX ONE

对外担保金融机构名单

截止一九八七年八月三十一日经国家外汇管理局批准下列金融机构办理外汇担保业务：

一、银行类：

1、中国银行及其分行；
2、汇丰银行上海分行；
3、汇丰银行深圳分行；
4、汇丰银行厦门分行；
5、标准渣打（麦加利）银行上海分行；
6、标准渣打（麦加利）银行厦门分行；
7、标准渣打（麦加利）银行深圳分行；
8、标准渣打（麦加利）银行珠海分行；
9、华侨银行上海分行；
10、东亚银行上海分行；
11、南洋商业银行深圳分行；
12、南洋商业银行蛇口分行；
13、珠海南通银行；
14、广东省银行深圳分行；
15、厦门国际银行；
16、国际商业信贷银行（海外）有限公司深圳分行；
17、大华银行厦门银行；
18、东方汇理银行深圳分行；
19、集友银行厦门分行；
20、法国兴业银行深圳分行；
21、美国建东银行厦门分行；
22、巴黎国民银行深圳分行；
23、东京银行深圳分行；
24、北海道拓殖银行深圳分行；
25、三和银行深圳分行；
26、中国工商银行广东省分行；
27、中国工商银行福建省分行；
28、中国工商银行上海市分行；
29、中国工商银行佛山分行；
30、中国工商银行汕头分行；
31、中国工商银行福州分行；
32、中国工商银行广州分行；
33、中国工商银行厦门市分行；
34、中国工商银行深圳市分行；
35、中国工商银行珠海市分行；
36、中国工商银行大连市分行；
37、中国工商银行四川省分行；
38、中国工商银行天津市分行；
39、中国农业银行佛山分行；
40、中国农业银行广州分行；
41、中国投资银行；
42、交通银行；
43、招商银行；
44、中信实业银行；
45、中国国际财务有限公司（示

二、信托、投资公司类：

1、中国国际信托投资公司，
2、中国工商银行信托投资公司，
3、上海市投资信托公司，
4、上海爱建金融信托投资公司，
5、广东国际信托投资公司，
6、福建投资企业公司，
7、厦门国际信托投资公司，
8、湖北省国际信托投资公司，
9、武汉国际信托投资公司，
10、天津市国际信托投资公司，
11、浙江省国际信托投资公司，
12、辽宁省国际信托投资公司，
13、中国银行信托咨询公司，
14、中国银行上海信托咨询公司，
15、中国银行天津国际信托投资公司，
16、中国银行珠江信托咨询公司，
17、中国银行重庆信托咨询公司，
18、中国银行北京信托咨询公司，
19、中国银行杭州信托咨询公司，
20、河北省国际信托投资公司，
21、中原开发信托投资总公司，
22、广州国际信托投资公司，
23、深圳国际信托投资总公司，
24、广东国际信托投资公司深圳分公司，
25、深圳经济特区发展财务公司，
26、广州国际信托投资公司经济技术开发区分公司，
27、佛山市信托投资总公司，
28、江苏省国际信托投资公司，
29、北京国际信托投资公司，
30、江西省国际信托投资公司，
31、沈阳国际信托投资公司，
32、重庆国际信托投资公司，
33、四川长江国际信托投资公司，
34、陕西省金融联合投资公司，
35、安徽省国际信托投资公司，
36、吉林省国际信托投资公司，
37、河南省国际信托投资公司，
38、广西国际信托投资公司，
39、宁夏伊斯兰国际信托投资公司，
40、汕头国际信托投资公司，
41、湖南省国际信托投资公司，
42、大连国际信托投资公司，
43、南京市国际信托投资公司，
44、连云港市国际信托投资公司，
45、宁波国际信托投资公司，
46、山西经济开发投资公司，
47、中国新技术创业投资公司，
48、光大金融公司，
49、中国工商银行天津市信托投资公司，
50、中国工商银行重庆分行信托投资公司，
51、中国对外贸易租赁公司，
52、新疆国际信托投资公司，
53、中国电子租赁有限公司，
54、福建华侨投资公司，
55、广东国际租赁公司，
56、温州国际信托投资公司，
57、北京旅游信托投资公司，
58、黑龙江国际信托投资公司，
59、中国租赁有限公司，
60、珠海市信托投资公司，
61、西安国际信托投资公司，
62、丹东国际信托投资公司，
63、江门国际信托投资公司，

APPENDIX 2

INVESTMENT APPROVAL CEILINGS

LOCATION	CEILINGS
A. Provisions, Autonomous Regions, and Open Cities	US$5 million
Except - Beijing	US$10 million
Fujian	US$10 million
Guangdong	US$10 million
B. Special Economic Zones - Shantou, Shenzhen, Xiamen, Zhuhai	RMB 30 million to 100 million (depending on type of industry)
C. Coastal Cities, Hainan Island	
- Shanghai, Tianjin	US$30 million
- Dalian, Guangzhou	US$10 million
- Hainan Island	US$5 million

APPENDIX 3

FEASIBILITY STUDY CHECKLIST

PART I GENERAL DATA

* Joint Venture ("JV") name, location, objective
* Description of partners (include sponsor in China and name of persons with primary responsibility for the project)
* Business scope, legal format (limited liability company) and duration
* JV administrative structure (include name and number of positions to be filled)
* Summary of total investment

---Proportion, value, and form of each partner´s contribution

---Loan details, if applicable

PART II MARKET ANALYSIS

* Current and future market for product

---Sales estimate (total and by price category)

---Projected foreign and domestic distribution

---Local industry conditions and prospects

* Past product imports and projected trends
* Role of the industry in national economy
* Anticicapted competition (local foreign)

PART III LOCATION AND SITE

* Land (site) use arrangement (include land-use fee and local department in charge if land not part of equity contribution)
* Complete layout of JV plant/buildings and capacity
* Infrastructure improvements required

PART IV PRODUCTION/OPERATION PLAN

* Quality of product/service (include international technical standards if appropriate)
* Estimated annual output/turnover (both before project reaches full capacity and each year thereafter)
* Transport and local storage requirements
* Product testing and quality control
* Trial production procedures and equipment
* Products, by-products, and waste (include estimated annual cost of waste disposal)
* Environmental protection plan (include projected pollution problems and treatment)
* Details on separate work locations, if applicable (input/output of each location, amount processed annually, value added at each facility, labour costs)

PART V MATERIAL INPUTS

* Approximate input requirements for all materials
* Present and potential sources of supply

* Availability of utilities, especially power
* Transport routes planned
* Rough estimate of annual cost of local and foreign inputs

PART VI PROJECT ENGINEERING

* Description of technology and equipment to be used
* Cost estimate (include, if applicable, technology transfer fees, royalty rate, and terms of payment)
* Rough layout of proposed equipment and costs
* Rough layout of civil engineering works and costs

PART VII ORGANIZATION AND OVERHEAD COSTS

* Planned organization structure (production, sales, administration, management)
* Estimated overhead (factory/operations, administrative, financial)

PART VIII MANPOWER

* Estimated manpower requirements (local/foreign staff by major category of skills)
* Units where employees will come from and positions they will fill
* Estimated wage scales, including overhead
* Personnel training plan

PART IX FINANCIAL AND ECONOMIC EVALUATION

* Estimated total investment costs (include working capital, fixed assets and amortization)
* Project financing

---Proposed capital structure

---Proportion and value of each partner's contribution

---Terms of proposed financing, if applicable

* Production cost

---Initial establishment/installation cost

---Annual operation cost, analyzed by work location if applicable

---Cost of technology, training, material inputs, transport, utilities, overhead

* Levy of taxes, duties, insurance (include expected rebates, reductions, and exemptions)
* Financial evaluation based on above-cost estimates (factoring in inflation)
* Projected annual profits (RMB and foreign currency)
* Profit distribution plan
* Cost analysis for products to be introduced later on, if applicable
* Statement of plan for balancing foreign exchange income and expenditure (must be separately approved by MOFERT or local FERTC depending on size and nature of project)
* Evaluation of project impact on the national economy

PART X JV IMPLEMENTATION SCHEDULE

* Overall time schedule proposed
* Schedule for preliminary operations and estimated cost
* Subcontractors and consultants involved (Chinese and foreign)

PART XI ACCOMPANYING DOCUMENTATION

Indicate documents to be prepared, by whom, and specific responsibilities:

* Market studies, technical studies, economic studies, as applicable
* Accounting statements
* Financing plan
* Written guarantees granted to investers, if applicable
* Written statements of opinion from relevant government organizations
* Formulation of JV agreement and/or contract
* Formulation of the JV articles of incorporation
* Other relevant documents, understandings, agreements

PART XII WORK PLAN PRECEDING ESTABLISHMENT OF THE JV

* Detailed plan for each stage of feasibility study, work chart

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